

with respect to a shareholder, stock in the noncontrolled 10-percent owned foreign corporation is characterized as a passive category asset in the hands of the shareholder if such shareholder does not meet the ownership requirements described in section 904(d)(2)(E)(i)(II).

(d) *Treatment of notes*—(1) *General rule.* For further guidance, see § 1.861-12T(d)(1).

(2) *Characterization of related controlled foreign corporation notes.* The debt of a controlled foreign corporation is characterized in the same manner as the interest income derived from that debt obligation. See §§ 1.904-4 and 1.904-5(c)(2) for rules treating interest income as income in a separate category.

(e) Portfolio securities that constitute inventory or generate primarily gains. For further guidance, see § 1.861-12T(e) through (i).

(f)–(j) [Reserved]

(k) *Applicability date.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018. Paragraphs (c)(2)(i)(A) and (c)(2)(i)(B)(1)(ii) of this section also apply to the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, the taxable year in which or with which such taxable year of the foreign corporation ends.

[T.D. 9452, 74 FR 27874, June 11, 2009, as amended by T.D. 9866, 84 FR 29335, June 21, 2019; T.D. 9882, 84 FR 69069, Dec. 17, 2019]

**§ 1.861-12T Characterization rules and adjustments for certain assets (temporary).**

(a) *In general.* For further guidance, see § 1.861-12(a).

(b) *Inventories.* Inventory must be characterized by reference to the source and character of sales income, or sales receipts in the case of LIFO inventory, from that inventory during the taxable year. If a taxpayer maintains separate inventories for any federal tax purpose, including the rules for establishing pools of inventory items under sections 472 and 474 of the Code, each separate inventory shall be separately characterized in accordance with the previous sentence.

(c) *Treatment of stock*—(1) *In general.* Subject to the adjustment and special rules of paragraphs (c) and (e) of this section, stock in a corporation is taken into account in the application of the asset method described in § 1.861-9T(g). However, an affiliated group (as defined in § 1.861-11T(d)) does not take into account the stock of any member in the application of the asset method.

(2) *Basis adjustment for stock in non-affiliated 10 percent owned corporations*—

(i)(A)–(C) [Reserved]. For further guidance, see § 1.861-12(c)(2)(i)(A) through (c)(2)(i)(C).

(ii) *10 percent owned corporation defined*—(A) *In general.* The term “10 percent owned corporation” means any corporation (domestic or foreign)—

(1) Which is not included within the taxpayer’s affiliated group as defined in § 1.861-11T(d) (1) or (6).

(2) In which the members of the taxpayer’s affiliated group own directly or indirectly 10 percent or more of the total combined voting power of all classes of the stock entitled to vote, and

(3) Which is taken into account for purposes of apportionment.

(B) *Rule of attribution.* Stock that is owned by a corporation, partnership, or trust shall be treated as being indirectly owned proportionately by its shareholders, partners, or beneficiaries. For this purpose, a partner’s interest in stock held by a partnership shall be determined by reference to the partner’s distributive share of partnership income.

(iii) *Earnings and profits of lower-tier corporations taken into account.* For purposes of the adjustment to the basis of the stock of the 10 percent owned corporation owned by the taxpayer under paragraph (c)(2)(i) of this section, the earnings and profits of that corporation shall include its pro rata share of the earnings and profits (or any deficit therein) of each succeeding lower-tier 10 percent owned corporation. Thus, a first-tier 10 percent owned corporation shall combine with its own earnings and profits its pro rata share of the earnings and profits of all such lower-tier corporations. The affiliated group shall then adjust its basis in the stock of the first-tier corporation by its pro

rata share of the total combined earnings and profits of the first-tier and the lower-tier corporations. In the case of a 10 percent owned corporation whose tax year does not conform to that of the taxpayer, the taxpayer shall include the annual earnings and profits of such 10 percent owned corporation for the tax year ending within the tax year of the taxpayer, whether or not such 10 percent owned corporation is owned directly by the taxpayer.

(iv) *Special rules for foreign corporations in pre-effective date tax years.* Solely for purposes of determining the adjustment required under paragraph (c)(2)(i) of this section, for tax years beginning after 1912 and before 1987, financial earnings (or losses) of a foreign corporation computed using United States generally accepted accounting principles may be substituted for earnings and profits in making the adjustment required by paragraph (c)(2)(i) of this section. A taxpayer is not required to isolate the financial earnings of a foreign corporation derived or incurred during its period of 10 percent ownership or during the post-1912 taxable years and determine earnings and profits (or deficits) attributable under section 1248 principles to the taxpayer's stock in a 10 percent owned corporation. Instead, the taxpayer may include all historic financial earnings for purposes of this adjustment. If the affiliated group elects to use financial earnings with respect to any foreign corporation, financial earnings must be used by that group with respect to all foreign corporations, except that earnings and profits may in any event be used for controlled foreign corporations for taxable years beginning after 1962 and before 1987. However, if the affiliated group elects to use earnings and profits with respect to any single controlled foreign corporation for the 1963 through 1986 period, such election shall apply with respect to all its controlled foreign corporations.

(v) *Taxpayers using the fair market value method.* Because the fair market value of any asset which is stock will reflect retained earnings and profits, taxpayers who use the fair market value method shall not adjust stock basis by the amount of retained earn-

ings and profits, as otherwise required by paragraph (c)(2)(i) of this section.

(3) *Characterization of stock of controlled foreign corporations—(i) Operative sections.* For further guidance, see § 1.861-12(c)(3)(i).

(ii) *Asset method.* Under the asset method, the taxpayer characterizes the tax book value or fair market value of the stock of a controlled foreign corporation based on an analysis of the assets owned by the controlled foreign corporation during the foreign corporation's taxable year that ends with or within the taxpayer's taxable year. This process is based on the application of § 1.861-9T(g) at the level of the controlled foreign corporation. In the case of a controlled foreign corporation that owns stock in one or more lower-tier controlled foreign corporations in which the United States taxpayer is a United States shareholder, the characterization of the tax book value of the fair market value of the stock of the first-tier controlled foreign corporation to the various separate limitation categories of the affiliated group must take into account the stock in lower-tier corporations. For this purpose, the stock of each such lower-tier corporation shall be characterized by reference to the assets owned during the lower-tier corporation's taxable year that ends during the taxpayer's taxable year. The analysis of assets within a chain of controlled foreign corporations must begin at the lowest-tier controlled foreign corporation and proceed up the chain to the first-tier controlled foreign corporation. For purposes of this paragraph (c), the value of any passive asset to which related person interest is allocated under § 1.904-5(c)(2)(ii) must be reduced by the principal amount of indebtedness on which such interest is incurred. Furthermore, the value of any asset to which interest expense is directly allocated under § 1.861-10T must be reduced as provided in § 1.861-9T(g)(2)(iii). See § 1.861-9T(h)(5) for further guidance concerning characterization of stock in a related person under the fair market value method.

(iii) *Modified gross income method.* For further guidance, see § 1.861-12(c)(3)(iii).

(4) [Reserved] For further guidance, see § 1.861-12(c)(4).

(d) *Treatment of notes*—(1) *General rule.* Subject to the adjustments and special rules of this paragraph (d) and paragraph (e) of this section, all notes held by a taxpayer are taken into account in the application of the asset method described in § 1.861-9T(g). However, the notes of an affiliated corporation are subject to special rules set forth in § 1.861-11T(e). For purposes of this section, the term “notes” means all interest bearing debt, including debt bearing original issue discount.

(2) *Characterization of related controlled foreign corporation notes.* For further guidance, see § 1.861-12(d)(2).

(e) *Portfolio securities that constitute inventory or generate primarily gains.* Because gain on the sale of securities is sourced by reference to the residence of the seller, a resident of the United States will generally receive domestic source income (and a foreign resident will generally receive foreign source income) upon sale or disposition of securities that otherwise generate foreign source dividends and interest (or domestic source dividends and interest in the case of a foreign resident). Although under paragraphs (c) and (d) of this section securities are characterized by reference to the source and character of dividends and interest, the source and character of income on gain or disposition must also be taken into account for purposes of characterizing portfolio securities if:

(1) The securities constitute inventory in the hands of the holder, or

(2) 80 percent or more of the gross income generated by a taxpayer's entire portfolio of such securities during a taxable year consists of gains.

For this purpose, a portfolio security is a security in any entity other than a controlled foreign corporation with respect to which the taxpayer is a United States shareholder under section 957, a noncontrolled section 902 corporation with respect to the taxpayer, or a 10 percent owned corporation as defined in § 1.861-12(c)(2)(ii). In taking gains into account, a taxpayer must treat all portfolio securities generating foreign source dividends and interest as a single asset and all portfolio securities generating domestic source dividends as a single asset and shall characterize the total value of that asset based on

the source of all income and gain generated by those securities in the taxable year.

(f) *Assets funded by disallowed interest*—(1) *Rule.* In the case of any asset in connection with which interest expense accruing at the end of the taxable year is capitalized, deferred, or disallowed under any provision of the Code, the adjusted basis or fair market value (depending on the taxpayer's choice of apportionment methods) of such an asset shall be reduced by the principal amount of indebtedness the interest on which is so capitalized, deferred, or disallowed.

(2) *Example.* The rules of this paragraph (f) may be illustrated by the following example.

*Example.* X is a domestic corporation which uses the tax book value method of apportionment. X has \$1000 of indebtedness and \$100 of interest expense. X constructs an asset with an adjusted basis of \$800 before interest capitalization and is required under the rules of section 263A to capitalize \$80 in interest expense. Because interest on \$800 of debt is capitalized and because the production period is in progress at the end of X's taxable year, \$800 of the principal amount of X's debt is allocable to the building. The \$800 of debt allocable to the building reduces its adjusted basis for purposes of apportioning the balance of X's interest expense (\$20).

(g) *Special rules for FSCs*—(1) *Treatment of FSC stock.* No interest expense shall be allocated or apportioned to stock of a foreign sales corporation (“FSC”) to the extent that the FSC stock is attributable to the separate limitation for certain FSC distributions described in section 904(d)(1)(H). FSC stock is considered to be attributable solely to the separate limitation category described in section 904(d)(1)(H) unless the taxpayer can demonstrate that more than 20 percent of the FSC's gross income for the taxable year consists of income other than foreign trading income.

(2) *Treatment of assets that generate foreign trade income.* Assets of the related supplier that generate foreign trade income must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source

income derived from transactions generating foreign trade income.

(i) *Value of assets attributable to foreign source income.* The value of assets attributable to foreign source general limitation income is computed by multiplying the value of assets for the taxable year generating foreign trading gross receipts by a fraction:

(A) The numerator of which is foreign source general limitation income for the taxable year derived from transactions giving rise to foreign trading gross receipts, after the application of the limitation provided in section 927(e)(1), and

(B) The denominator of which is total income for the taxable year derived from the transaction giving rise to foreign trading gross receipts.

(ii) *Value of assets attributable to domestic source income.* The value of assets attributable to domestic source income is computed by subtracting from the total value of assets for the taxable year generating foreign trading gross receipts the value of assets attributable to foreign source general limitation income as computed under paragraph (g)(2)(i) of this section.

(h) *Special rules for DISCs—(1) Treatment of DISC stock.* No interest shall be allocated or apportioned to stock in a DISC (or stock in a former DISC to the extent that the stock in the former DISC is attributable to the separate limitation category described in section 904(d)(1)(F)).

(2) *Treatment of assets that generate qualified export receipts.* Assets of the related supplier that generate qualified export receipts must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source income derived from transactions during the taxable year from transactions generating qualified export receipts.

(i)-(j) [Reserved]

(k) *Effective/applicability date.* The rules of this section apply for taxable

years beginning after December 31, 1986.

[T.D. 8228, 53 FR 35495, Sept. 14, 1988, as amended by T.D. 9260, 71 FR 24526, Apr. 25, 2006, T.D. 9452, 74 FR 27875, June 11, 2009; T.D. 9456, 74 FR 38875, Aug. 4, 2009; T.D. 9866, 84 FR 29336, June 21, 2019; T.D. 9882, 84 FR 69070, Dec. 17, 2019]

**§ 1.861-13 Special rules for characterization of controlled foreign corporation stock.**

(a) *Methodology.* For purposes of allocating and apportioning deductions for purposes of section 904 as the operative section, stock in a controlled foreign corporation owned directly or indirectly through a partnership or other pass-through entity by a United States shareholder is characterized by the United States shareholder under the rules described in this section. In general, paragraphs (a)(1) through (5) of this section characterize the stock of the controlled foreign corporation as an asset in the various statutory groupings and residual grouping based on the type of income that the stock of the controlled foreign corporation generates, has generated, or may reasonably be expected to generate when the income is included by the United States shareholder.

(1) *Step 1: Characterize stock as generating income in statutory groupings under the asset or modified gross income method—(i) Asset method.* A United States shareholder of a controlled foreign corporation that apportions its interest expense on the basis of assets must characterize stock of the controlled foreign corporation using the asset method described in § 1.861-12T(c)(3)(ii) to assign the assets of the controlled foreign corporation to the statutory groupings described in paragraphs (a)(1)(i)(A)(I) through (10) and (a)(1)(i)(B) of this section. If the controlled foreign corporation owns stock in a lower-tier noncontrolled 10-percent owned foreign corporation, the assets of the lower-tier noncontrolled 10-percent owned foreign corporation are assigned to a gross subpart F income grouping to the extent such assets generate income that, if distributed to the controlled foreign corporation, would